# Finance, Growth, and Opportunity: Policy Challenges

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# Finance matters for growth

- Mobilizes savings
- Chooses where to allocate those savings
- Monitors the use of that capital after it is allocated
- Provides mechanisms for pooling and diversifying risks

# Finance matters for growth

- By affecting the allocation of resources
  - By shaping the rate of technological change
  - Not, by altering the savings rate
- By boosting competition in the nonfinancial sector
  - Facilitating the entry of more efficient new firms
  - Facilitating the exit of less efficient old firms

# Finance matters for equality of opportunity

- Finance influences
  - Who can start a business.
  - Who can acquire a good education
  - Who can live in a neighborhood conducive to the healthy development of children
- Finance influences the degree to which a person’s economic opportunities are bounded by individual skill and initiative, or whether familiar wealth, social status, and political connections largely delineate the contours of one’s economic horizons.

# Finance matters for equality of opportunity

- Evidence
  - Greater competition in finance yields disproportionately positive effects for the poor
  - Finance expands economic opportunities indirectly, by improving labor market conditions.
- Political challenges are clear

# Financial innovation and growth

- Growth literature focuses on technological innovation
- New technologies frequently require new financial arrangements
  - Financial innovation assists technological innovation
  - Historical evidence:
    - Ancient development of tradable debt contracts
    - Railroad required new financial intermediaries, financial reporting, and accounting systems
    - Venture capital supported information technology
    - Amendments to venture capital model have supported biotechnologies.

# Some initial policy implications

- Improvements in finance will generate winners and losers. Politics matters for which policies are actually implemented.
- Finance matters for human welfare beyond crises.
- Financial regulation must adapt to financial innovation

# Financial regulation and growth

1. What did we think worked best?
2. Does the crisis reject this wisdom?

# What works best? Some basic lessons

- Don’t forget what 30 years of research suggests about the grabbing hand of government in finance.
- The evidence does not support laissez faire either
- The evidence stresses the value of:
  - Forcing transparency
  - Regulations that compel equity and debt holders to oversee financial intermediaries.
  - Regulations that facilitate the ability of equity and debt holders to monitor and influence financial intermediaries.
  - Regulations that refrain from impeding the ability and incentives of equity and debt holders to govern financial institutions.

# Does the US crisis reject these lessons?

- I don't think so.
- U.S. policies:
  - hindered transparency,
  - erected barriers to shareholders and creditors effectively monitoring the activities of financial institutions, and
  - created incentives for financial institutions to take excessive risks.
- The U.S. did not follow the basic lessons.

# Conclusions

1. Finance affects the major engines of economic growth
2. There are guidelines for growth-enhancing financial policies
3. Politics is the greatest challenge in implementing these guidelines